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SIPDIS

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TAGS: ECON CE ECONOMICS
SUBJECT: Sri Lankan Economy Continues to Grow Despite Confusion Over Policies

¶1. (U) SUMMARY: The Sri Lankan economy grew by 5.2% in the second quarter, following 6.2% growth in the first quarter. Consequently, first half GDP growth is estimated around 5.7% and the Central Bank is optimistic of 5 to 5.5% overall growth in 2004. The Bank attributes the growth this year to the continuation of economic momentum following the signing of the ceasefire agreement. The economy, however, faces several challenges: high oil bills, drought in agricultural districts, deficit in the Balance of Payments, inflationary pressures, subsidy costs, stalemate in the peace front and economic uncertainty. The GSL seems to be coming around to the realization that fiscal restraint is needed, and is making some efforts to curb subsidies, but its prospects for long-term success on this front are poor. End Summary.

GDP Growth Continues

¶2. (U) The Sri Lankan economy grew by 5.2 percent in the second quarter, down from 6.2 percent in the first quarter. Second quarter growth was fueled by a strong services sector, which grew by 7.1 percent. Within services, telecommunications, port services, import trading and banking did well. The agriculture sector declined slightly. Tea, rubber and coconuts increased, but rice recorded a 12 percent decline due to drought. Growth in factory output slowed to 3 percent from 9 percent in 2003.

External sector

¶3. (U) As the oil bill soared and aid flows slowed, the BOP recorded a USD 223 million deficit in the first half of 2004 from a USD 187 million surplus for the same period in ¶2003. On the bright side, exports gained from continuing global economic recovery and rose by 10 percent. Tourism, foreign inward remittances and shipping also recorded healthy growth and partly offset the huge trade deficit, caused by a 21 percent rise in imports. The trade deficit increased to USD 1.1 billion in the first half of 2004 (2004H1) from 0.7 billion in 2003H1. The oil bill was $539 million in 2004H1 compared with $375 million in 2003H1. The treasury expects it to rise further to about $1.2 billion by year-end. Import of machinery and other investment goods also increased. The current account deficit was $428 million compared with a deficit of $1.5 million in 2003.

¶4. (U) Capital inflows have slowed. Government borrowing declined to $284 million in 2004H1 compared to $315 million in 2003H1, as IMF and WB have withheld program loans to Sri Lanka while the new Government pursues its development plan. To cover the shortfall, the government hopes to borrow up to US$400 million through dollar bond issues in ¶2004. The Central Bank said that FDI inflows remained at last year's levels -- around $100 million. Outflows have increased due to a large investment abroad by a local bank. Portfolio investment saw a drastic drop to just US $6 million as investors sought greater clarity in government policy on the economic and peace fronts. The worsening BOP situation resulted in official reserves declining to $2.1 billion by June from $2.3 billion in December 2003. Total reserves declined to $3.1 billion from $3.2 billion, providing 5.2 months of import cover.

¶5. (U) The Central Bank recently said that a small BOP surplus for the second half of 2004 could be expected if privatization proceeds from the sale of a petroleum retail unit and program loans flow in and oil returns to below $40 a barrel - neither of which appears likely at this point. Without such changes, the BOP deficit for the full year could exceed $200 million.

Exchange rate, interest rate and inflation

¶6. (U) Exchange rates, interest rates and prices are under severe pressure due to BOP deficit, government subsidies and price hikes. The government has, however, been able to temporarily keep a tight rein through state intervention in both money and exchange markets. Despite Central Bank intervention, in which the bank sold USD 235-300 million, the rupee depreciated by 6.2 percent by the end of August. The news of an increased BOP deficit has further weakened

the rupee. It is currently trading at around 104 rupees to the dollar.

¶7. (U) As of the end of September, the Central Bank maintained its interest rates, despite rising inflation and exchange rate pressures. T-bill rates, which increased by about 200 basis points through July 2004, have started to decline in the last few auctions as state institutions increased buying, reportedly on instructions from the Finance Ministry. The current 3 month T-bill rate is about 7 percent compared with 7.26 percent a year ago. The average prime-lending rate is around 9.68 percent compared with 9.32 percent a year ago.

¶8. (U) The money supply expanded by about 18 percent in July as both private and public sector credit grew. The Central Bank has expressed concern about the high growth in public sector credit due to subsidies on petroleum, wheat and several other services. The Bank said that the impact could be mitigated by revising prices, which would also support interest and exchange rate stability.

¶9. (U) Inflation has once again become a major concern to the Government and policy makers. Average inflation as measured by the Colombo Consumer Price Index (CCPI) was 5.4 percent in September. A much faster rate of inflation was indicated in the point-to-point change (September 2004/September 2003) in the index, which rose by 11.6 percent as the full effect of recent price hikes began to be captured by the index. Prices have been rising as a result of oil price hikes, depreciation of the rupee, and lower agricultural supplies due to a drought. Inflationary pressures will rise further in the coming months due to price hikes on petroleum, transport, and electricity announced in late September.

Government fiscal operations

¶10. (U) On the fiscal front, the GSL Treasury maintains that the budget deficit for 2004 will be 8%, despite subsidy costs and increased government recruitment. The treasury has said that subsidies up to Rs 8 billion could be accommodated within a deficit of 8 percent of GDP. According to reports, subsidies on petroleum alone have amounted to about Rs 7.5 billion (USD 75 million) so far this year. The government has begun to gradually raise the price of petroleum products (gasoline and diesel), electricity, and public bus transport. Even with prices recently allowed to rise on diesel, kerosene, and wheat flour, these products are still subsidized. Sri Lanka has sought, with only marginal success, OPEC assistance (concessionary financing through the OPEC fund) to ease the pressure on government finances. Some of the price increases requested by the private sector (such as bus fares, wheat flour, cooking gas) are under intense debate.

¶11. (U) The Central Bank expects investment will continue to achieve a higher growth in the medium term. Future investment will depend on several factors affecting consumer and investor confidence: political stability, a resumption of, and progress in, the peace talks, improvements in macroeconomic management, greater fiscal control, improved clarity in economic policy, reduced price distortions, improved infrastructure, structural reforms, and effective utilization of donor assistance.

Comment

¶12. (SBU) While the picture is not dire on the economic front, it could be far better, particularly with exports surging as they are. It appears that monetary policy is looser than might be expected despite increasing interest rates and a weakening rupee. While the depreciating rupee should be good for Sri Lankan exports, much of its effect is offset by the increasing cost of imported inputs for the export sector. The losses of IMF and World Bank budgetary support magnify the balance of payments problem even more.

¶13. (SBU) Continued floundering and a failure of the Government to speak with one voice on matters of economic policy will continue to send the wrong signals to markets and potential investors. During upcoming TIFA talks in Washington, USG interlocutors will hear from the GSL that they intend to "stay the course" on economic reform. This is only partially true. The current Government has taken privatization off the table and cuts to subsidies are just now beginning to be considered, as continuing price increases bring home the reality of the nation's fiscal situation. The GSL has begun to change its tone, with the President recently commenting that subsidies are no longer sustainable and should not be expected to continue. Whether this rhetoric will translate into concrete action on the fiscal front is questionable. The President's coalition remains tethered to a socialist firebrand party

(JVP) with keen interests in seeing continued payouts for its constituent base in the rural, poor southern regions.
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